

INTERNAL REVENUE SERVICE

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The Honorable Ed Pastor  
U.S. House of Representatives  
Washington, D.C. 20515

Attention: Eve Young

Dear Mr. Pastor:

This letter is in response to your inquiry dated October 11, 2000, asking for clarification of [REDACTED] letter of September 22, 2000. Your inquiry concerns income tax withholding on military disability payments.

Your understanding of *St. Clair v. U.S.*, 778 F. Supp. 894 (E.D. Va. 1991), is that disability does not have to be combat-related for the individual to receive tax-free treatment, and the IRS agreed to follow this case. You believe the IRS is not allowing tax-exempt treatment of disability payments unless they are the result of a combat-related injury because of agency regulations. [Internal Revenue Code (the Code) section 104(b)(2)(C).] I would like to provide information to clarify these conclusions.

The standards for military disability payments are established by section 104(a)(4) and (b) of the Code, which allows taxpayers to exclude from gross income "amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country."

However, effective in 1976, Congress adopted section 104(b), which restricts the income exclusion in 104(a)(4), so the general rule is that military disability pay is included in income unless the individual:

- Received disability payments because of combat-related injury, or
- "On application therefor... would be entitled to receive disability compensation from the Veterans' Administration." [Section 104(b)(2)(C) and (D).<sup>1</sup>]

The *St. Clair* case (copy enclosed) dealt only with section 104(a)(4). The holding in *St.*

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<sup>1</sup>Section 104(b)(2) also contains exclusions for individuals who receive payments whose tax-exempt status was grandfathered on or before September 24, 1975. This exclusion is unlikely to be relevant today.

*Clair* is that a lump-sum disability severance payment is received as a result of personal injuries occurring during active service. The IRS argued that under case law a lump-sum payment could not be retroactively recharacterized as a disability payment. The IRS also argued the taxpayer was not entitled to the income tax exclusion because he received a lump-sum payment that was not a pension or annuity for purposes of section 104(a)(4). The court found for the taxpayer, and the IRS agreed with the holding in that case, as explained in Action On Decision 1992-006 (copy enclosed) the formal statement of IRS policy on this issue.

The *St. Clair* case did not deal with the additional restrictions on tax treatment adopted by Congress in section 104(b)(2). The IRS has never held the position that section 104(b)(2) restricts the exclusion only to combat-related injuries.

The withholding problem to which you refer arises only when the disability is not combat-related. Then, for the severance pay to be tax-exempt, the service member must be awarded disability compensation from the Veterans Administration (VA) after retirement.

The Department of Defense (DOD) cannot know in advance whether a member will be entitled to receive disability compensation from the VA. Because of the way the law is written, the tax treatment of a lump-sum disability payment is established after the payment is made. First the member must retire or separate from service and then apply to the VA for disability benefits. Not until the VA decides does the member know whether he can exclude the disability payment from income. If the decision is made in a tax year after the payment, the member must file an amended income tax return to claim the exclusion. This must be done before the statute of limitations for refunds expires.

The DOD regulations (copy enclosed) dealing with withholding on disability payments explain that disability severance pay is normally taxable income. [DOD Financial Management Regulation, Vol. 7A, Ch. 35, section 3504. See particularly section 350404, Taxability and Withholding.] This regulation also explains that disability severance pay is not taxable or subject to withholding if:

- It resulted from a combat-related injury, or
- The member has official notification from the VA approving entitlement to disability compensation.

Otherwise DOD withholds income taxes. If the VA awards disability compensation in the same tax year in which the member receives disability compensation, the member can request a refund from the DOD. If the VA awards disability compensation in another tax year, the member must file an amended return with the IRS to request a refund.

Under the Freedom of Information Act, we will make this letter available to the public after we delete names, addresses, and other identifying information.

I hope this information is helpful to you. If you have any questions, please call Elizabeth Edwards of this office at (202) 622-6040.

Sincerely,

Mary Oppenheimer  
Assistant Chief Counsel  
Office of Division Counsel/  
Associate Chief Counsel  
(Tax Exempt and Government Entities)

Enclosures (3)